CALCULATION OF THE ADJUSTMENT TO THE LIMITED LIABILITY COMPANY FEES FOR 2001

December 2000

CALIFORNIA FRANCHISE TAX BOARD

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EXECUTIVE SUMMARY

Referencing the methodology and assumptions set forth in the report dated August 9, 1994, and titled “Methodology for the Limited Company Fee Adjustment Calculation,” Section 17943 of the California Revenue and Taxation Code directs the Franchise Tax Board to conduct a study of Limited Liability Companies (LLC). This study is to be conducted on or before January 1, 1999, and annually thereafter. This report fulfills the requirement for the study to determine LLC fee amounts applicable to income year 2001.

Using the methodology and assumptions set forth in the referenced report, this study indicates that SB 469 (Statutes of 1994, Chapter 1200) produced a net tax loss of $65.0 million in 1998. When the 2000 LLC fee amounts are taken into account, the revenue loss is eliminated and, there is, instead, a revenue gain of $4.2 million. To eliminate the resulting revenue gain, it is necessary to reduce the fee amounts 6.0 percent below their 2000 levels. The current and adjusted LLC fee schedules are shown in Table 1 below. The fee adjustment calculation is sensitive to the underlying economic conditions. Thus, future LLC fees might have to be adjusted significantly on an annual basis, depending on future economic conditions.

Table 1: Current and Adjusted LLC Fee Schedules.

Total Income Level	Initial Fee	1999 Fee	2000 Fee	2001 Fee
Below $250,000	$ 0	$ 0	$ 0	$ 0
$ 250,000 or more, but less than $ 500,000	$ 500	$ 865	$ 1,042	$ 979
$ 500,000 or more, but less than $ 1,000,000	$ 1,500	$ 2,595	$ 3,126	$ 2,938
$ 1,000,000 or more, but less than $ 5,000,000	$ 3,000	$ 5,190	$ 6,251	$ 5,876
$ 5,000,000 or more	$ 4,500	$ 7,785	$ 9,377	$ 8,814

1. INTRODUCTION

In 1994, the California Legislature passed and the Governor signed into law SB 469 (Statutes of 1994, Chapter 1200). This legislation allows businesses to operate within California as limited liability companies. This business form can have several tax impacts, both at the entity level and at the passthrough level. Because of concern about the potential overall revenue impact of allowing LLCs to operate, this bill also included a requirement that, on or before January 1, 1999, and annually thereafter, the Franchise Tax Board conduct a study to estimate the revenue impact of the enactment of SB 469. The Franchise Tax Board is then required to calculate an appropriate adjustment to the limited liability company (LLC) total income fee. The fee is to be adjusted so that, in total, it fully offsets the revenue loss of allowing limited liability companies to operate in California. The methodology and assumptions for performing this calculation are set forth in a report dated August 9, 1994, and titled "Methodology for the Limited Liability Company Fee Adjustment Calculation." This report is referenced in Section 17943 of the California Income Tax Code. This study, the 2000 Franchise Tax Board LLC Study, implements the required methodology.

The next section provides descriptive data on the LLCs and their members. Section 3 presents the methodology used in this study. Section 4 discusses the revenue impact of SB 469 and required adjustments to the LLC fee rate. Appendix 1 reproduces the original report describing the methodology to be used. Appendix 2 provides detailed discussion of the parameters and assumptions used in each stage of the calculation.

2. DESCRIPTIVE DATA FOR LLCs

This section presents descriptive information regarding California's LLCs.

Table 2.1 shows the number of LLC registrations, returns received, and taxes and fees paid from 1994 to 1999. As expected, each of these categories has shown substantial growth since 1994, when LLCs were first allowed. The number of LLC returns filed with the FTB has increased from 678 in 1994 to 43,321 in 1998. The amount of LLC tax paid increased from $526,000 in 1994 to $34.7 million in 1998. The LLC fee paid increased from $237,000 in 1994 to $33.2 million in 1998.

Table 2.2 provides data on the distribution of LLCs by size of total income (including all receipts and any nonbusiness income). About 75 percent of the LLCs have total income less than $500,000, while three percent of the LLCs have total income more than $5,000,000. LLCs with total income of more than $500,000 but less than $5,000,000, account for more than 60 percent of all fees paid.

Table 2.3 shows the distribution of LLCs by industry. Almost 42 percent of LLCs are in the real estate industry, 25 percent are in the service industry, and four percent of LLCs are in manufacturing. The remaining LLCs are in other industries.

Table 2.1: Growth of Limited Liability Companies from 1994 to 1999
Monetary Amounts are in $ Thousands

	1994	1995	1996	1997	1998	1999+
LLC Registrations *	920	7,817	12,549	18,645	24,898	26,221
LLC Returns Received	678	6,487	15,877	28,909	43,321	27,671
LLC Tax Paid	$526	$5,026	$12,486	$22,845	$34,657	$274
LLC Fee Paid**	$237	$2,334	$10,034	$20,702	$33,228	$157
Nonresident Member Withholding	$12	$185	$822	$692	$202	$0
Total Receipts	$775	$7,544	$23,341	$44,239	$68,727	$430

Source: Business Entities Section (through 11/19/00)

* Registrations are reported for the year of registration. All other amounts are reported on an income-year basis.

** For 1997, LLC Fee Paid does not include fees paid by single-member LLCs.

+ Data for 1999 are incomplete.

Table 2.2: Number, Tax, and Fee Paid by LLCs by Level of Total Income for 1998
Monetary Amounts are in $ Thousands

Variable	Level of Total Income					Total
	Less Than $250,000	**$250,000 to $500,000**	**$500,000 to $1 Million**	**$1 Million to $5 Million**	**More Than $5 Million**	
Number	27,833	4,519	3,716	4,829	2,423	43,321
Fees	0	2,260	5,574	14,488	10,906	33,228
Taxes	22,266	3,615	2,973	3,864	1,939	34,657

Table 2.3: Number, Tax, and Fee Paid by LLCs by Industry in 1998
Monetary amounts are in $ Thousands

Industry	Manufacturing	Real Estate	Services	Other	Total
Number	1,571	18,012	10,658	13,080	43,321
Fees	2,093	10,507	8,613	12,015	33,228
Taxes	1,257	14,410	8,526	10,464	34,657

Table 2.4 shows the distribution of LLCs and their distributed income by income level and size of total income. The loss-LLCs tend to be more heavily distributed among the LLCs with total income less than $500,000. For LLCs with income less than $500,000, those with losses outnumber those with gains by about 40 percent. For the larger LLCs, those with gains outnumber those with losses by about 130 percent. These large LLCs make up for over 95 percent of all gains, and about 65 percent of all losses.

Table 2.5 shows the distribution of LLC members by entity types. About 70 percent of all LLC members are individuals. Next in the order of the number of members are trusts/estates (12 percent) and C-corporations (six percent). For all entity types except others, the number of members receiving zero income or passthrough losses exceeds those receiving passthrough gains.

Table 2.4: Number of LLCs and Their Distributed Income by Income Type and Level of Total Income.

Monetary Amounts are in $ Millions.

Distributed Income Type	**Variable**	**Level of Total Income**					**Total**
		Less Than $250,000	**$250,000 to $500,000**	**$500,000 to $1 Million**	**$1 Million to $5 Million**	**More Than $5 Million**	
Gain	Number	8,484	2,867	2,457	3,293	1,583	18,684
	Income	469	291	452	2,080	14,551	17,843
Zero	Number	4,650	202	81	191	193	5317
	Income	0	0	0	0	0	0
Loss	Number	14699	1450	1177	1345	648	19,320
	Income	-3138	-247	-511	-756	-5,081	-9,733
Total	Number	27833	4,519	3,716	4,829	2,423	43,321
	Income	-2,670	44	-59	1,324	9,470	8,110

Note: Distributed income is income before being apportioned to California, as reported on line 23 of Schedule K, Form 568.

Table 2.5: Number of LLCs' Members and Their Distributed Income in 1998 by Business and Income Levels. Monetary Amounts Are in $ Millions.

Business Type	Income Type	Number	Distributed Income
C-Corporation	Gain	5,009	6,711
	Zero	2,172	0
	Loss	6,134	-5,635
S-Corporation	Gain	1,681	650
	Zero	785	0
	Loss	1,666	-707
LLC	Gain	2,929	2,465
	Zero	1,195	0
	Loss	2,527	-1,270
General Partnership	Gain	663	207
	Zero	573	0
	Loss	758	-140
Limited Partnership	Gain	2,446	2,566
	Zero	922	0
	Loss	3,153	-481
Individual	Gain	59,257	4,415
	Zero	17,094	0
	Loss	66,816	-1,315
Trusts/ Estates	Gain	11,822	610
	Zero	3,422	0
	Loss	9,445	-183
Others	Gain	2,828	219
	Zero	12	0
	Loss	1,680	-2
Subtotal	Gain	86,636	17,843
	Zero	26,175	0
	Loss	92,177	-9,733
Total	All	204,988	8,110

Note: Distributed income is income before being apportioned to California on line 23 of Schedule K, Form 568.
* Others include IRA and exempt organizations.

3. METHODOLOGY

This section provides additional information regarding the specific methodology used in this study. The general methodology to estimate the revenue impact of LLC legislation and the required LLC fee rate adjustment is first briefly reviewed. More detailed information about the various estimation steps are then discussed in the later part of the section. A full description of the data, parameters, and assumptions used in this study is provided in Appendix 2.

3.1 General Methodology

The revenue impact of LLC legislation for the 1998 tax year is computed as the difference between the taxes and fees that are paid by the LLCs for the 1998 tax year and the amount that would have been paid had LLCs not been allowed to operate in California. Data from the 1998 tax year were used for this analysis, because 1998 data are the most current data available. A fundamental assumption for this calculation is that, if LLCs were not allowed to operate in California as LLCs, each LLC would still choose to do business in California, but would do so as some other type of entity; i.e., a C-corporation, an S-corporation, a limited partnership, or a general partnership. For the purposes of this report, the entity that an LLC would have been in the absence of SB 469 is referred to as the alternative entity, and abbreviated AE. For both the LLC and its respective AE, the total tax revenue includes taxes paid directly by the LLCs and the AEs[1], as well as taxes by the members of the LLCs and AEs as a result of their passthrough income or losses. Taxes and fees paid directly by LLCs and AEs are referred to as entity taxes, while taxes paid by members of LLCs and AEs are referred to as passthrough taxes. This computation is performed for each LLC record from a sample of LLC tax returns. The individual results are then aggregated across all records of the sample and statistically weighted to the LLC population. The difference between the taxes paid by the AEs and by the LLCs is divided by total LLC fees collected under the current fee structure. This ratio is multiplied by the current fee (at each level) to determine the appropriate fee.

3.2 Data Sources

The key source of data used for this study is a stratified random sample of 4,001 tax returns (Form 568) filed by the LLCs for the 1998 tax year. The sampling procedure was stratified by total income – returns with greater total income were generally selected at higher rates than returns with smaller total incomes. Weighting factors are assigned to each record of the sample so that the sample can be aggregated to represent accurately the total income classes for the population of 1998 returns. In total, these 4,001 returns in the sample represent 43,321 returns in the population. For each LLC return, data were collected directly from the LLC return and from the Schedules K-1 filed with the LLC return. Additionally, the return for each member was located and data for each member were collected.[2] The following variables were collected from the tax returns of the LLCs and their members:

<u>LLC entity variables</u>

Name and ID number
Industrial code
Number of members
Total income

[1] Note that we do not include LLC fees in this calculation. The reason that fees are not included is that, for methodological purposes, the fee is viewed as essentially an adjustment to make up for any revenues that are lost by the allowance of LLCs. Therefore, this analysis ignores fees for purposes of determining the extent of the revenue loss and then calculates the fee on the basis of that loss.

[2] Not all LLC members filed returns with the Franchise Tax Board. Therefore, the sample only includes member-return data for those members who filed returns.

Ordinary income
Distributive Income
Total fee and tax paid
Credit
Cash and property distribution
Name of entities liquidated
Business types of entities liquidated
Liquidation gains

LLC member variables (Schedule K-1)

Name and identification number of member
Entity type
Member's share of profit or loss
Credit
Cash and property distribution

LLC member tax return variables

Adjusted Gross Income (for individuals)
Adjusted Total Income (for estates/trusts)
Income Distribution Deduction (for estates/trusts)
Taxable Income
Tax

For this last group of variables, the FTB Business Entity Tax System (BETS) Summary Transaction File, the FTB PIT Return Merge File, and the FTB Fiduciary Tax Return Data File, and the FTB Taxpayer Information System were used.

3.3 Assigning LLCs to Alternative Entities (AE)

The 1994 paper referenced by SB 469 specifies the method of assigning LLCs to AE types. Four AE types are considered: C corporations, S corporation, general partnership, and limited partnership. The assignment of the LLCs to these AE types is done through a stochastic process in which the probability that an LLC of a certain size and industry is assigned to a particular AE type is equal to the actual distribution of this entity within the corresponding size and industry grouping for the entire population of business entities.[3] Table 3.1 presents the distribution used for this procedure.

[3] The stochastic process is not used for LLCs which report that they were formed by liquidating another business entity, such as a partnership or a corporation. In that case, it is assumed that this liquidation would not have taken place and that the business entity would have continued in the form that it was. Corporate joint ventures were also assumed to take a partnership AE type. Additionally, some LLCs have some members who are receiving loss distributions while others are receiving gain distributions. This type of situation is not allowed for a C-corporation or S-corporation. Therefore, the existence of different classes of ownership for an LLC is used to make the inference that, if LLCs were not allowed in California, the business would have chosen to form as a partnership, for which different classes of partners are allowed.

Table 3.1: Distribution of Business Type within Each Industry by Level of Total Income (%).

Industry	Business Type	Level of Total Income			Total
		Less Than $500,000	$500,000 to $5 Million	More Than $5 Million	
Manufacturing	C-corporation	57	72	75	67
	S-corporation	23	25	24	4
	General Partnership	18	3	1	8
	Limited Partnership	2	0	0	1
	Subtotal	100	100	100	100
Real Estate	C-corporation	24	56	63	26
	S-corporation	10	29	19	11
	General Partnership	41	9	11	38
	Limited Partnership	26	6	7	24
	Subtotal	100	100	100	100
Services	C-corporation	50	65	64	54
	S-corporation	20	23	30	21
	General Partnership	26	11	6	21
	Limited Partnership	4	1	1	3
	Subtotal	100	100	100	100
Other	C-corporation	41	67	73	52
	S-corporation	16	22	23	19
	General Partnership	36	9	3	24
	Limited Partnership	8	2	1	5
	Subtotal	100	100	100	100
Total All Industry	C-corporation	40	66	72	49
	S-corporation	16	23	25	18
	General Partnership	33	9	3	25
	Limited Partnership	11	2	1	8
	Subtotal	100	100	100	100

Source: C and S-corporation data came from Bank and Corporation Sample.
Total general and limited partnership data came from Business Entity Tax System database.
Partnership data by industry and size came from the Business Master File and Business Returns Tax File of the Department of Treasury.

Due to the stochastic nature of the AE assignment process, a single estimation might seriously overstate or understate the true revenue impact of LLC legislation. To eliminate the possibility that extreme estimates would result in unwarranted fee adjustments, a Monte Carlo statistical technique is employed. This technique involves repeating the above estimation procedure ten times. Each time, the LLCs are stochastically reassigned to the AEs using the same assignment probability. The final estimation result is chosen to be the median-value estimate from these 10 iterations.

3.4 Calculate Entity-Level Tax for LLCs and Alternative Entities (AE)

The only entity-level tax for LLCs is the $800 annual LLC tax. If an LLC had liquidated a corporation in order to form the LLC and if that liquidation resulted in taxable gains, the tax on those gains, at the statutory C-corporation rate, is calculated. In addition to these two taxes, LLCs are required to pay a fee based on their total income. The 1998 LLC fee schedule is shown in the Table 3.2.

Table 3.2: 1998 LLC Fee Schedule

Total Income Level	Fee
Below $250,000	$ 0
$ 250,000 or more, but less than $ 500,000	$ 500
$ 500,000 or more, but less than $ 1,000,000	$ 1,500
$ 1,000,000 or more, but less than $ 5,000,000	$ 3,000
$ 5,000,000 or more	$ 4,500

3.4.1 Entity Tax for C-Corporation AE

The income the LLC would have had if it had been a C-corporation is estimated as the sum of LLC distributed income, a depreciation adjustment, and an NOL adjustment that would have been available to the C-corporation. The depreciation adjustment is needed in cases in which an LLC was formed by liquidating a corporation. If that liquidation results in taxable gains, the asset basis for the LLC is greater than the basis would have been for the C-corporation. Thus, the depreciation adjustment is needed to account for the reduced basis that the C-corporation would have had relative to that of the LLC.

The NOL adjustment is needed because C- and S-corporations are allowed to use 50 percent of their losses from previous years (with certain time limitations) to offset income in the current year. Since LLCs only face an entity tax of the annual LLC tax of a fixed amount and not an income-based tax, NOLs from previous years do not affect the annual LLC tax (see Appendix 3.4.1).

This income is apportioned to California using the LLC apportionment factor to obtain the amount that would have been the C-corporation's State Net Income (SNI). A statutory tax rate of 8.84 percent for C-corporations is applied to this SNI. Available LLC credits will be deducted from the calculated tax. The resulted tax after credit is set to be not below the statutory minimum franchise tax of $800.

3.4.2 Entity Tax for S-Corporation AE

The entity-level tax when the AE is an S-corporation is computed in a similar manner as in the case where the AE is a C-corporation. The only difference is that the statutory tax rate for S-corporations is 1.5 percent.

3.4.3 Entity Tax for General Partnership AE

The entity-level tax when the AE is a general partnership is zero.

3.4.4 Entity Tax for Limited Partnership AE

The entity-level tax when the AE is a limited partnership is the $800 annual limited partnership tax.

3.5 Calculate Passthrough Taxes for LLCs

Taxes on the LLC's passthrough income and credit are computed separately for each of the LLC's members. The computation varies by member type.

3.5.1 Passthrough Tax for Individual Members

For an individual member, the first step is to calculate the appropriate amount of passthrough income. First, the amount of income passed through to an individual member is computed as the product of the LLC distributed income and that member's share.[4] If the member is a nonresident, this product is further apportioned to California using the LLC's apportionment factor. Next, the member's tax is calculated with the LLC income included in taxable income. Finally, the member's tax is calculated with the LLC passthrough income backed out of taxable income. The difference between the taxes calculated in these two calculations is the tax effect of the LLC passthrough income. For individual members who did not file a return with the Franchise Tax Board, a calculated marginal tax rate was applied to the passthrough income to determine the tax impact.

3.5.2 Passthrough Tax for C-corporation Members

If the passthrough recipient is a C-corporation, the computation is similar. First, the amount of income passed through to a C-corporation member is computed as the product of the LLC distributed income and the member's share. This product is then multiplied by the LLC's apportionment factor to determine the California taxable passthrough income for that C-corporation member. The tax is calculated, as with the individual returns, both with and without the LLC passthrough income. The difference between the taxes calculated in these two calculations is the tax effect of the LLC passthrough income. With C-corporations, there is a secondary impact, because a C-corporation may pass through income in the form of dividends to its shareholders. This model assumes a dividend pay-out rate of nine percent.[5] This dividend payout is assumed to be taxed at the calculated average tax rate for the passthrough of positive income to individual members (that is, not partnerships, C-corporations, etc.) of LLCs. For C-corporation members who did not file a return with the Franchise Tax Board, a calculated marginal tax rate is applied to the passthrough income to determine the tax impact.

3.5.3 Passthrough Tax for S-corporation Members

If the passthrough recipient is an S-corporation, the computation is similar to the one used for C-corporation. One difference, however, is that S-corporation's income is taxed at 1.5 percent,

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[4] A member's share is the percentage of the LLC that is owned by that member.

[5] When corporations pay out dividends, corporate income is subject to a second layer of tax. The dividend payout rate for LLCs of 9 percent is based on information reported by corporations on their federal M-1s.

instead of 8.84 percent. Also, the whole amount of LLC passthrough income received by the S-corporation is passed through again to its shareholders. This secondary passthrough income is taxed at the average rate paid by individual members. For S-corporation members who did not file a return with the Franchise Tax Board, a calculated marginal tax rate was applied to the passthrough income to determine the tax impact.

3.5.4 Passthrough Tax for General Partnership Members

If the passthrough recipient is a general partnership, the passthrough income has no impact at the partnership level. The whole passthrough amount is then assumed to be passed through to the partnership's partners. This secondary passthrough is taxed at the average rate paid by individual members.

3.5.5 Passthrough Tax for Limited Partnership Members

If the passthrough recipient is a limited partnership, the passthrough income has no impact at the partnership level. The whole passthrough amount is then assumed to be passed through to the partnership's partners. This secondary passthrough is taxed at the average rate paid by individual members.

3.5.6 Passthrough Tax for Estates and Trusts

In the cases in which estates or fiduciaries are not passing income through to their beneficiaries, their passthrough income is taxed at the average rate paid by individual members on gains. Passthrough losses are likewise taxed at the average rate paid by individual members on losses for estate and trust members who did not file a return with the Franchise Tax Board, a calculated marginal tax rate was applied to the passthrough income to determine the tax impact.

If an estate or fiduciary is passing income through to its beneficiaries, a different set of calculations is used. The first step in this set of calculations for an estate or fiduciary is to determine what percentage of its income is being passed through to its beneficiaries. The percentage is calculated as the quotient of the income distribution deduction divided by the sum of the income distribution deduction and adjusted total income. It is then assumed that whatever income (or loss) was passed through from the LLC to the member estate or fiduciary will be passed through to the member's beneficiaries in proportion to the distribution of total income. Thus, this calculated percentage is then multiplied by the income passed through by the LLC to determine the amount of income that is taxed to the estate or fiduciary and the amount that is taxed at the level of the beneficiary. For the amount of income taxed to the estate or fiduciary, the calculation of the tax amount proceeds as described in the paragraph above. Income that is deemed to have been passed through to beneficiaries is taxed at the marginal tax rate for PIT LLC members in our sample.

3.5.7 Passthrough Tax for LLC members

In some cases, the LLC member is itself an LLC. If the LLC member does not do business in California, the ownership of an LLC doing business in California will subject the member LLC to the $800 annual LLC tax and the LLC fee. For LLC members that do business in California, the passthrough income has no tax impact at the LLC level, but does have a potential impact on the amount of LLC fee paid. The whole passthrough amount is then assumed to be passed through to the LLC's members. This secondary passthrough is taxed at the average rate paid by individual members.

3.6 Calculate Passthrough Taxes for Alternative Entities (AEs)

In general, the method of calculating the passthrough tax for the AEs does not depend on what type of entity the member is. The method employed for this study is to calculate a marginal tax rate for each member for the LLC passthrough income. It is then assumed that the member would face the same average tax rate for AE passthrough income as for LLC passthrough income. In many cases, the AE passthrough income received by a member is identical to the LLC passthrough income received by that member. These income amounts can be different if the AE has NOL or depreciation adjustments (see Section 3.4.1), or if the AE was a C-corporation. If the AE was a C-corporation, it would only be passing through nine percent of gains if they had positive income, and they would be passing through none of their losses if they had negative income.

4. RESULTS

This section presents the results of the study, especially estimates of the revenue impact of the LLC legislation for 1998, and the required adjustment to the current LLC fee rates. It also discusses the sensitivity of the results to various assumptions and economic conditions.

Table 4.1 shows estimates of the revenue impact, ignoring the LLC fee, of the LLC legislation for 1998 by type of passthrough income and size of the LLCs. The net revenue loss of SB 469 for the tax year 1998 is estimated at $65.0 million. LLC fees of $33.2 million partially offset this revenue loss. Most of the revenue loss is associated with the LLCs with passthrough losses, although some positive income LLCs generated revenue losses..

Table 4.2 shows estimates of the tax impact of the LLC legislation for 1998 by type of industry and size of the LLCs. The net revenue impact of the LLCs for all sectors other than the manufacturing sector is negative.

Table 4.1: Number of LLCs and Tax Impact by Type of Distributed Income and Level of Total Income. Monetary Amounts Are in $ Million.

Distributed Income Type	Variable	Level of Total Income					Total
		Less Than $250,000	$250,000 to $500,000	$500,000 to $1 Million	$1 Million to $5 Million	More Than $5 Million	
Gain	Number	8,484	2,867	2,457	3,293	1,583	18,684
	Impact	4.2	*	-5.8	-18.8	31.8	11.4
Zero	Number	4,650	202	81	191	193	5,317
	Impact	1.3	*	*	*	*	1.3
Loss	Number	14,699	1,450	1,177	1,345	648	19,320
	Impact	-9.8	-1.7	-3.7	-15.6	-47.0	-77.8
Total	Number	27,833	4,519	3,716	4,829	2,423	43,321
	Impact	-4.4	-1.6	-9.4	-34.4	-15.2	-65.0

Note: Distributed income is income before being apportioned to California as reported on line 23 of Schedule K, Form 568.
* Amount less than $500,000.

Table 4.2: Number of LLCs and Tax Impact by Industry and Level of Total Income. Monetary Amounts Are in $ Million.

		Level of Total Income					
Industry	**Variable**	**Less Than $250,000**	**$250,000 to $500,000**	**$500,000 to $1 Million**	**$1 Million to $5 Million**	**More Than $5 Million**	**Total**
Manufac-Turing	Number	836	135	102	246	252	1,571
	Impact	-1.3	-.1	-.1	-.8	31.5	29.2
Real Estate	Number	12,099	2,226	1,624	1,551	512	18,012
	Impact	2.7	.7	-6.3	-11.6	-16.7	-31.1
Services	Number	6,390	1,349	1,077	1,311	531	10,658
	Impact	-1.3	-2.0	-1.8	-7.3	-13.7	-26.1
Other	Number	8,508	809	914	1,721	1,128	13,080
	Impact	-4.5	-.3	-1.2	-14.8	-16.3	-37.1
Total	Number	27,833	4,519	3,717	4,829	2,423	43,321
	Impact	-4.4	-1.6	-9.4	-34.4	-15.2	-65.0

* Amount less than $500,000.

The revenue impacts broken out by industry and type of distributed income are shown in Tables 4.1 and 4.2. These revenue impacts are based on the median of the simulations that we performed. This median revenue impact, calculated as required by the methodology paper referenced by Section 17943 of the California Revenue and Taxation Code, was a loss of $65.0 million.[6] The 1998 fee offset is $33.3 million. In order to estimate the adjustment to the LLC fees from its current (2000) level, we recomputed the 1998 fees using the 2000 fee amounts. The recomputed fees add up to $69.2 million. Thus, at 2000 fee amounts, LLCs would actually raise revenue. In order to offset the increase in revenue, LLC fees would need to raise $4.2 million less. To accomplish this, the fees would need to be reduced by 6.0% from the 2000 fees. The adjusted 2001 LLC fee schedule is shown in the Table 4.3 below.

Table 4.3: Current and Adjusted LLC Fee Schedule

Total Income Level	**Initial Fee**	**1999 Fee**	**2000 Fee**	**2001 Fee**
Below $250,000	$ 0	$ 0	$ 0	$ 0
$ 250,000 or more, but less than $ 500,000	$ 500	$ 865	$ 1,042	$ 979
$ 500,000 or more, but less than $ 1,000,000	$ 1,500	$ 2,595	$ 3,126	$ 2,938
$ 1,000,000 or more, but less than $ 5,000,000	$ 3,000	$ 5,190	$ 6,251	$ 5,876
$ 5,000,000 or more	$ 4,500	$ 7,785	$ 9,377	$ 8,814

4.1 Potential Volatility of the LLC Fee

It is likely that the LLC fee will need to be significantly adjusted from year to year. The LLC fee adjustment is particularly sensitive to the amount of losses that are reported by LLCs in each year. Data on the losses experienced by C-corporations show that the amount of losses reported

[6] Tax impact does not take into account the LLC fee that is intended to offset tax loss.

can vary significantly from year to year. Table 4.4 shows the percentage change in losses reported by C-corporations over the last 21 years. During that time span, two years show changes of over 50 percent, seven years show changes of over 20 percent, and 14 of the 20 years show changes of over 10 percent. It is likely that LLCs will experience similar volatility.

Table 4.4
Percentage Change in B&C losses

1998	22%
1997	3%
1996	11%
1995	7%
1994	-14%
1993	-2%
1992	15%
1991	3%
1990	22%
1989	9%
1988	16%
1987	9%
1986	11%
1985	6%
1984	22%
1983	-16%
1982	54%
1981	52%
1980	26%
1979	26%
1978	12%
1977	0%

Additionally, the LLC fee adjustment is subject to change due to changes in the marginal tax rates used (explicitly or implicitly) to calculate the tax impacts. For this fee adjustment calculation, the average marginal tax rates on LLC passthrough income were lower than the statutory maximum rates. This is particularly true for losses and gains passed through to C-corporations. These rates are subject to change if taxpayers have more gains to offset their loss passthroughs, or fewer losses to offset their gain passthroughs. It is unclear how these items will change over time. However, the fee adjustment calculation is very sensitive to the marginal tax rates used. Therefore, the marginal tax rate provides another potential source of volatility in the LLC fee.

APPEND1X 1

METHODOLOGY FOR THE
LIMITED LIABILITY COMPANY
FEE ADJUSTMENT CALCULATION

AUGUST 9, 1994

Table of Contents

Section 1: Overview of Methodology

Section 23093 of the Revenue and Taxation Code requires the Franchise Tax Board to annually, beginning January 1, 1999, conduct a study to estimate the ongoing revenue impact of the enactment of SB 469 of 1994, and to calculate an adjustment to the limited liability company (LLC) total income fee rates that would offset any revenue gain or loss. This report provides a detailed explanation of the methodology that will be employed to make this calculation.

The methodology for this calculation is based on a microsimulation approach that will determine the taxes and the total income fees that are paid by a sample of LLCs in a given year, and will estimate the taxes that these LLCs would have paid under existing laws assuming the organization and registration of LLCs was not permitted. The sample to which the microsimulation process will be applied will be selected so as to ensure a 95 percent level of confidence in the sample's representativeness of the population.

The amount of revenue related to LLCs that is being collected will be subtracted from the amount of revenue that would have been collected under laws that did not permit the organization or registration of LLCs. The difference between these two amounts will then be compared to the total amount of fees collected. One (1) plus the ratio of these two numbers (the numerator of which is the difference between the amount of revenue estimated under the two sets of laws, and the denominator of which is the total amount of fees collected) will then be multiplied by the existing fee rates (at each fee level) to arrive at the new fee rates. The income breakpoints will not be adjusted.

Section 2.A: LLC Fee

The LLC Fee will be calculated by using the reported LLC total income and applying the LLC fee schedule as prescribed in the Revenue and Taxation Code.

Section 2.B: LLC Minimum Tax

The statutory minimum tax for LLCs will be applied.

Section 2.C: Tax on LLC Passthrough Income

If the passthrough recipient is an individual, the individual's taxable income and net tax for the relevant year will be used to estimate what the individual's net tax is, and what it would have been in the absence of the LLC income or credit passthrough. The difference between these two figures is the tax on the passthrough.

If the passthrough recipient is a C-corporation, the corporation's state net income and net tax for the relevant year will be used to estimate what the corporation's net tax is, and what it would have been in the absence of the LLC income or credit passthrough. The difference between these two figures is the tax on the passthrough. The dividends paid by the C-corporation based on its LLC passthrough income will be estimated by multiplying the C-corporation passthrough income by the average dividend payout ratio for all C-corporations. The average tax rate applied to these dividends will be the average tax rate calculated on LLC income passed through to individuals.

If the passthrough recipient is an S-corporation, a procedure equivalent to the one described for C-corporations will be applied to obtain the entity level tax. The tax on the S-corporation passthrough will be calculated by applying the average marginal tax rate calculated on passthroughs to individuals (as described in the first paragraph of this section). Credits will be fully applied in the year they are generated.

If the passthrough recipient is a partnership, the average marginal tax rate calculated on passthroughs to individuals will be applied, and the full amount of the credit will be applied.

If the passthrough recipient is an exempt organization, the tax is zero.

Section 2.D: Tax on Liquidation Gains

Every LLC member with a greater than 10 percent ownership in the LLC, who obtained some portion of his/her LLC equity from the liquidation of a C-corporation or an S-corporation, is required to file an informational return with the FTB to disclose the amount of any liquidation gain or loss resulting from the corporate liquidation. Both complete corporate liquidations and transactions involving a stock sale treated as an asset sale are included as liquidations. The LLC member is also required to indicate whether the liquidated corporation was a C-corporation or an S-corporation.

Liquidation gains will be taxed at 9.3 percent for liquidating C-corporations and at 1.5 for liquidating S-corporations.

It is assumed that the liquidation gains for the corporation shareholders are zero.

Section 3.A: Determination of the Type of Entity the LLC would have been Under Law Without LLC Provisions

The following procedure will be applied to estimate stochastically the type of entity - C-corporation, S-corporation, general partnership, or limited partnership - that the LLC would have been in the absence of enactment of SB 469 of 1994.

An average distribution for 1991 through1993 of business entities across entity-type categories will be calculated by size and industry categories. The size categories, based upon total income, are:

. less than $500 thousand,
. between $500 thousand and $5 million,
. more than $5 million

The industry categories are:

. manufacturing
. real estate
. services
. other

The LLCs would be stochastically allocated to the various entity-type categories so as to approximate the average distribution of business entities over entity types by industry and size classification for 1991 through 1993.

The tax that this entity, along with its passthrough recipients, would have paid would then be estimated as described below. The total amount of tax revenue that would have been collected under law which did not permit the organization or registration of LLCs would be computed by weighting the computed tax for each entity by the entity's appropriate weight and summing up over all entities. Because the stochastic process used for determining entity types can result in an estimate that significantly overstates or understates (due to the stochastic element) the actual revenue cost of this legislation, a Monte Carlo statistical technique will be employed. The Monte Carlo technique involves repeating a stochastic procedure several times, allowing the stochastic element to vary, and choosing the median-valued estimate. This technique maintains the unbiasedness of the stochastic procedure while diminishing the variance around the true mean of the estimate. The Monte Carlo technique employed will use ten iterations.

Section 3.B.1: Entity Tax for C-corporations

The income that the LLC would have had if it had been a C-corporation will be calculated as the sum of the LLC profit, a depreciation adjustment (discussed below) for basis adjustments due to liquidation, and the previous net operating losses (discussed below) of the LLC that would have been available to the C-corporation to use the offset income. This income then will be multiplied by the LLCs apportionment factor to obtain the amount that would have been the C-corporation's State Net Income (SNI). The statutory C-corporation tax rate will then be applied to the calculated SNI. The LLC credits will be applied against the tax. The statutory minimum tax for C-corporations will be applied, if necessary.

The depreciation adjustment will be calculated using a two-step procedure. The first step, to estimate the adjustment for those LLCs that are newly formed, involves amortizing the amount of liquidation gain over ten years and adding this amortized amount to the income of the C-corporation. The second step is to calculate the depreciation adjustment for those LLCs that are not newly formed. To estimate this adjustment, it is necessary to first calculate, for the newly formed LLCs, the percentage of LLCs that have liquidation gains and, for those with liquidation gains, the average ratio of liquidation gains to total income. The first ratio will be used to stochastically estimate the already-existing LLCs that would have had liquidation gains. The dollar amount of liquidation gains would be estimated by multiplying the average ratio of liquidation gains to total income for newly formed LLCs with liquidating gains by the total income for each LLC that is stochastically estimate to have liquidation gains. The estimated amount of liquidation gains will be amortized over ten years and added to the income of the C-corporation. Those LLCs that have been LLCs for more than ten years would have no depreciation adjustment, since the amortization period is only ten years. The stochastic element of this estimation procedure will be allowed to vary under the Monte Carlo technique, which is described in Section 3.A.

The Net Operating Loss (NOL) adjustment will be calculated by analyzing the history of the LLC's profits and losses and determining the amount of NOL carryover that would have been available for the C-corporation.

Section 3.B.2: Tax on C-corporation Passthrough Income

The C-corporation dividends will be estimated by multiplying the average dividend to income ratio for C-corporations by the LLC total income. The average marginal tax rate for LLC passthrough income (discussed in Note 2.C) will be used to calculate the tax on the C-corporation dividends.

Section 3.C.1: Entity Tax for S-corporations

The income that the LLC would have had if it had been an S-corporation will be calculated as the sum of the LLC profit, a depreciation adjustment (discussed below) for basis adjustments due to liquidation, and the previous net operating losses (discussed below) of the LLC that would have been available to the S-corporation to use to offset income. This income will then be multiplied by the LLC's apportionment factor to obtain the amount that would have been the S-corporation's State Net Income (SNI). The SNI will be taxed at the statutory S-corporation tax rate. The LLC credits will be applied against the tax. The statutory minimum tax for S-corporations will be applied, if necessary.

The depreciation adjustment will be calculated using a two-step procedure. The first step, to estimate the adjustment for those LLCs that are newly formed, involves amortizing the amount of liquidation gain over ten years and adding this amortized amount of the income of the S-corporation. The second step is to calculate the depreciation adjustment for those LLCs that are not newly formed. To estimate this adjustment, it is necessary to first calculate, for the newly formed LLCs, the percentage of LLCs that have liquidation gains and, for those with liquidation gains, the average ratio of liquidation gains to total income. The first ratio will be used to stochastically estimate the already-existing LLCs that would have had liquidation gains. The dollar amount of liquidation gains would be estimated by multiplying the average ratio of liquidation gains to total income for newly formed LLCs with liquidation gains by the total income for each LLC that is stochastically estimated to have liquidation gains. The estimated amount of liquidation gains will be amortized over ten years and added to the income of the S-corporation. Those LLCs that have been LLCs for more than ten years would have no depreciation adjustment, since the amortization period is only ten years. The stochastic element of this estimation procedure will be allowed to vary under the Monte Carlo technique.

The Net Operating Loss (NOL) adjustment will be calculated by analyzing the history of each LLC's profits and losses and determining the amount of NOL carryover that would have been available for the S-corporation.

Section 3.C.2: Tax on S-corporation Passthrough Income

The S-corporation deemed-passthrough income will be estimated by the LLC deemed-passthrough income. The average marginal tax rate on LLC passthrough income will be applied to calculate the tax on S-corporation passthrough income.

LLC credits will be passed through to the S-corporation shareholders in proportion to their distributive shares. The credits will be fully deducted in the year they are earned.

Section 3.D.1: Tax on General-Partnership Passthrough Income

The general-partnership passthrough income will be estimated by the LLC deemed-passthrough income. The average marginal tax rate on LLC passthrough income will be applied to calculate the tax on general-partnership passthrough income.

LLC credits will be passed through to the partners in proportion to their distributive shares. The credits will be fully deducted in the year they are earned.

Section 3.E.1: Entity Tax for Limited Partnerships

The statutory minimum tax on limited partnerships will be applied.

Section 3.E.2: Tax on Limited-Partnership Passthrough Income

The limited-partnership passthrough income will be estimated by the LLC deemed-passthrough income. The average marginal tax rate on LLC passthrough income will be applied to calculate the tax on limited-partnership passthrough income.

LLC credits will be passed through to the partners in proportion to their distributive shares. The credits will be fully deducted in the year they are earned.

APPENDIX 2

Detailed Description of Methodology

This appendix provides detailed description of the data sources, parameters, and assumptions used in the 2000 Franchise Tax Board LLC Study. The sections are numbered to correspond to their respective sections within Chapter 3.

3.2 Sample Weights of the 1998 LLC Sample.

The key source of data used for this study is a stratified random sample of 4,001 tax returns (Form 568) filed by the LLCs for the 1998 tax year. The sampling procedure was stratified by total income – returns with greater total income were selected at higher rates than returns with smaller total incomes. Weighting factors are assigned to each record of the sample so that the sample can be aggregated to represent accurately the total income classes for the population of 1998 returns. The sample weights are shown in the Table A1 below.

Table A1: Sample Weights for the 1998 LLC Sample.

Total Income Level	Population	Sample	Weight
Less than -$1 million	84	83	1.01
-$1 million to -$1	802	76	10.55
Zero	8,258	162	50.98
$1 to $250K	18,688	368	50.78
$250K to $500K	4,519	134	33.72
$500K to $1 million	3,715	183	20.30
$1 million to $5 million	4,842	709	6.83
More than $5 million	2,413	2,286	1.06
Total	43,321	4,001	

3.3 Assigning LLCs to Alternative Entities (AE)

Data Sources for the AE Assignments

The source of data for the distribution of C and S-corporations is the FTB Bank and Corporation Sample. The source of data for the distribution of general and limited partnership is the FTB Business Entity Tax System data base, the IRS Business Master File, and Business Returns Transaction File. Table A2 shows the population distribution of the above four entity types by size and industry.

Exceptions to Stochastic AE assignment

The first exception is for those LLCs that report liquidation gains on their Schedule O of their state tax returns. The AE assigned to these LLCs is the AE listed on the same schedule.

The second exception is for joint ventures. An LLC was determined to be a joint venture if its only members were corporations who each owned at least 20 percent of the LLC.

The third exception is for LLCs which have members with different types of membership. Some LLCs have some members who are receiving loss distributions while others are receiving gain distributions. This type of situation is not allowed for a C-corporation or S-corporation. Therefore, the existence of different classes of membership for an LLC is used to make the inference that, if LLCs were not allowed in California, the business would have chosen to form as a partnership, for which different classes of partners are allowed.

Table A.2: Distribution of Business Type within Each Industry by Level of Total Income (%).

Industry	**Business Type**	**Level of Total Income**			**Total**
		Less Than $500,000	**$500,000 to $5 Million**	**More Than $5 Million**	
Manufacturing	C-corporation	57	72	75	67
	S-corporation	23	25	24	4
	General Partnership	18	3	1	8
	Limited Partnership	2	0	0	1
	Subtotal	100	100	100	100
Real Estate	C-corporation	24	56	63	26
	S-corporation	10	29	19	11
	General Partnership	41	9	11	38
	Limited Partnership	26	6	7	24
	Subtotal	100	100	100	100
Services	C-corporation	50	65	64	54
	S-corporation	20	23	30	21
	General Partnership	26	11	6	21
	Limited Partnership	4	1	1	3
	Subtotal	100	100	100	100
Other	C-corporation	41	67	73	52
	S-corporation	16	22	23	19
	General Partnership	36	9	3	24
	Limited Partnership	8	2	1	5
	Subtotal	100	100	100	100
Total All Industry	C-corporation	40	66	72	49
	S-corporation	16	23	25	18
	General Partnership	33	9	3	25
	Limited Partnership	11	2	1	8
	Subtotal	100	100	100	100

Source: C and S-corporation data came from Bank and Corporation Sample.
Total general and limited partnership data came from Business Entity Tax System database.
Partnership data by industry and size came from the Business Master File and Business Returns Tax File of the Department of Treasury.

3.4.1 Entity Tax for C-Corporation AE

Liquidation Gains

Liquidation gains are taxed at the statutory rate for C-corporations, 8.84 percent.

Depreciation Adjustment

The depreciation adjustments are calculated differently and separately for newly formed LLCs and for LLCs that have been in operation for more than one year. For newly formed LLCs, the depreciation adjustment is equal to the reported liquidation gains amortized over ten years. For older LLCs, data on liquidation gains are not available, and the depreciation adjustment is derived in two stages. First, it is assumed that the percentage of the older LLCs having liquidation gains is the same as that of newly formed LLCs. The LLC Sample indicates that only 0.2 percent of all newly formed LLCs had liquidation gains. This percentage is used to stochastically select the older LLCs that have liquidation gains. Next, among the selected LLCs, the amount of liquidation gains is computed as the product of the LLCs' total income and the average ratio of liquidation gains over total income. The later ratio, .65, is computed from the newly formed LLCs with liquidation gains. Finally, liquidation gains are amortized over ten years to derive depreciation adjustments that are added to the income of C-corporations.

NOL Adjustment

The NOL adjustment is calculated from the LLC's ordinary income for tax years 1994 through 1997. Only 50 percent of the LLCs' losses can be used in the computation of NOL carryover that would have been available for C-corporations.

3.4.2 Entity Tax for S-Corporation AE

Depreciation Adjustment

The depreciation adjustments are calculated separately for newly formed LLCs and for LLCs that have been in operation for more than one year. For newly formed LLCs, depreciation adjustment is equal to the reported liquidation gains amortized over ten years. For older LLCs, data on liquidation gains are not available, and the depreciation adjustment is derived in two stages. First, it is assumed that the percentage of the older LLCs having liquidation gains is the same as that of newly formed LLCs. The LLC Sample indicates that only 0.2 percent of all newly formed LLCs have liquidation gains. This percentage is used to stochastically select the older LLCs that have liquidation gains. Next, among the selected LLCs, the amount of liquidation gains is computed as the product of the LLCs' total income and the average ratio of liquidation gains over total income. The later ratio, .65, is computed from the newly formed LLCs with liquidation gains. Finally, liquidation gains are amortized over ten years to derive depreciation adjustments that are added to the income of S-corporations.

NOL Adjustment

The NOL adjustment is calculated from the LLC's ordinary income for tax years 1994 through 1997. Only 50 percent of the LLCs' losses can be used in the computation of NOL carryover that would have been available for S-corporations.

3.5.1 Passthrough Tax for Individual Members

Credits and Alternative Minimum Tax

To account for the possibility of tax credits and alternative minimum tax, a tax amount is calculated on the member's reported taxable income. The difference (which can be positive or negative) between this calculated tax and the amount reported by the taxpayer is the net of all credits and alternative minimum tax. This net amount is subtracted from the tax that is calculated with the LLC passthrough income backed out of taxable income. This credit and AMT adjustment is then applied to the taxpayer's computed regular tax without LLC passthrough income to derive his tax liability without LLC passthrough income. Any credits that are passed through from the LLC to the individual member are added back to the taxpayer's computed regular tax without LLC passthrough income.

Tax Rate Adjustment

When calculating the tax impact of LLC passthrough income, a potential bias exists, due to the way the data are structured, and does not facilitate the analysis of all the LLC passthrough income for a particular individual. The data included information on all the members of each LLC in the sample. However, if a member is a member in more than one LLC, it is impossible to know that from the data we have. Analysis with this type of data can lead to an understatement of tax rates for gain passthroughs, and an overstatement of tax rates for loss passthroughs. This bias can be illustrated through the following example. In this example, for simplicity, it is assumed that there is one tax rate of 10 percent. If a taxpayer has taxable income of $0, which includes $10,000 of LLC passthrough income and $10,000 of LLC passthrough losses, the tax impact calculated for the gain passthrough would be $0, since the tax on taxable income is $0, and the tax on taxable income less the $10,000 LLC gain would also be $0. The tax impact calculated for the loss passthrough would be $1,000, since the tax on taxable income is $0, and the tax on taxable income less the $10,000 LLC loss would be $1,000. Thus, it would, in this case, be estimated that the passthrough gain had a effective marginal rate of 0 percent, and the passthrough loss would have an effective rate of 10 percent. This clearly cannot be accurate, because the taxpayer paid no tax on his taxable income.

In order to adjust for this potential bias, the average tax rate for individual members was calculated using the standard approach of taking the difference between the tax on taxable income and the tax on taxable income minus any LLC passthrough. Then an average tax rate was calculated in which the difference was taken between the tax on taxable income and the tax on taxable income minus an adjusted LLC passthrough. This adjusted LLC passthrough is equal to the individual's passthrough times one minus the ratio of losses to gains (for gain passthroughs), or one minus the ratio of gains to losses (for loss passthroughs). This method essentially allocates to each LLC individual member gains (if that member has a passthrough loss) or losses (if that member has a passthrough gain) such that that member has a ratio of gains and losses that is the same as that of the population of individual members. This method corrects for the bias discussed above. The tax rate calculated without any adjustment for gains passed through to individual members is 8.14 percent. With the adjustment, the effective marginal rate is 8.55 percent. For loss passthroughs, the tax rates are 8.95 percent and 5.40 percent, respectively.

The tax rate for gains is adjusted by the ratio of 8.55 to 8.14, or 1.05. The tax rate for loss passthroughs is adjusted by the ratio of 5.40 to 8.95, or 0.60.

Returns not Filed

Some individual members did not file returns with the Franchise Tax Board. For these taxpayers, the tax impact for gain passthroughs is assumed to be equal to the members' shares of LLC passthrough income times a tax rate of 8.55 percent, the adjusted average rate for individual members discussed above. The tax impact for loss passthroughs is assumed to be zero, under the assumption that the reason no return was filed was that the member had no filing requirement.

3.5.2 Passthrough Tax for C-corporation Members

Credits and Alternative Minimum Tax

To account for the possibility of credits and alternative minimum tax, a tax amount was calculated on the member's reported taxable income. The difference (which can be positive or negative) between this calculated tax and the amount reported by the taxpayer is the net of all credits and alternative minimum tax. This net amount is subtracted from the tax that is calculated with the LLC passthrough income backed out of taxable income. This credit and AMT adjustment are then applied to the taxpayer's computed regular tax without LLC passthrough income to derive his tax liability without LLC passthrough income. Any credits that are passed through from the LLC to the S-corporation member are added back to the taxpayer's computed regular tax without LLC passthrough income

Tax Rate Adjustment

For this adjustment's rationale, see A.3.5.2. The tax rate calculated without any adjustment for gains passed through to C-corporation members is 4.27 percent. With the adjustment, the effective marginal rate is 7.60 percent. For loss passthroughs, the tax rates are 4.83 percent and 3.60 percent, respectively.

The tax rate for gains is adjusted by the ratio of 7.60 to 4.27, or 1.78. The tax rate for loss passthroughs is adjusted by the ratio of 3.60 to 4.83, or 0.74

Returns not Filed

Some C-corporation members did not file returns with the Franchise Tax Board. For these taxpayers, the tax impact for gain passthroughs is assumed to be equal to the members' shares of LLC passthrough income times a tax rate of 7.60 percent, the adjusted average rate for C-corporation members discussed above. It is assumed that, if a C-corporation member did not file a return with the Franchise Tax Board and that member received a passthrough loss, the loss would not have a tax effect, since the member did not report any positive income for the loss to offset.

Dividend Pay-out Ratio

The dividend payout ratio for C-corporation is estimated as the ratio of corporate total cash distribution over income subject to tax. Using the 1994 corporate Statistics of Income tally from the Department of Treasury, Office of Tax Analysis, this ratio was calculated to be nine percent for corporations with assets greater than $100,000 and less than $10,000,000.

Tax Rate for Secondary Passthrough

The tax rate applied to the secondary passthrough of LLC income through C-corporations is the average adjusted rate for LLC individual members, 8.55 percent. If the C-corporation member did not file a return with the Franchise Tax Board, the tax rate was set on its secondary passthrough income at the average rate for LLC individual members, 8.55 percent. C-corporation members do not have passthrough losses.

3.5.3 Passthrough Tax for S-corporation Members

Credits and Alternative Minimum Tax

To account for the possibility of credits and alternative minimum tax, a tax amount was calculated on the member's reported taxable income. The difference (which can be positive or negative) between this calculated tax and the amount reported by the taxpayer is the net of all credits and alternative minimum tax. This net amount is subtracted from the tax that is calculated with the LLC passthrough income backed out of taxable income. This credit and AMT adjustment are then applied to the taxpayer's computed regular tax without LLC passthrough income to derive his tax liability without LLC passthrough income. Any credits that are passed through from the LLC to the C-corporation member are added back to the taxpayer's computed regular tax without LLC passthrough income

Tax Rate Adjustment

For this adjustment's rationale, see A.3.5.2. The tax rate calculated without any adjustment for gains passed- through to S-corporation members is .66 percent. With the adjustment, the effective marginal rate is 1.05 percent. For loss passthroughs, the tax rates are 1.04 percent and 0.20 percent, respectively.

The tax rate for gains is adjusted by the ratio of 1.05 to 0.66, or 1.59. The tax rate for loss passthroughs is adjusted by the ratio of 0.20 to 1.04, or 0.19.

Returns not Filed

Some S-corporation members did not file returns with the Franchise Tax Board. For these taxpayers, the tax impact for gain passthroughs is assumed to be equal to the members' shares of the of LLC passthrough income times a tax rate of 1.05 percent, the adjusted average rate for S-corporation members discussed above. It is assumed that, if an S-corporation member did not file a return with the Franchise Tax Board and that member received a passthrough loss, the loss would not have a tax effect, since the member did not report any positive income for the loss to offset. Therefore, the tax impact for loss passthroughs is zero.

Tax Rate for Secondary Passthrough

The tax rate applied to the secondary passthrough of LLC income through S-corporations is the average adjusted rate for LLC individual members, 8.55 percent. The tax rate applied to the secondary passthrough of LLC losses through S-corporations is the average adjusted rate for LLC individual members, 5.40 percent. If the S-corporation member did not file a return with the Franchise Tax Board, the tax rate was set on its secondary passthrough income at the average rate for LLC individual members, 8.55 percent for gains. If the S-corporation member did not file a return with the Franchise Tax Board and it received an LLC passthrough loss, the tax on this loss is zero.

3.5.4 Passthrough Tax for General Partnership Members

Tax Rate for Secondary Passthrough

The tax rate applied to the secondary passthrough of LLC income through general partnerships is the average adjusted rate for LLC individual members, 8.55 percent. The tax rate applied to the secondary passthrough of LLC losses through general partnerships is the average adjusted rate for LLC individual members, 5.40 percent. If the general partnership member did not file a return with the Franchise Tax Board, the tax rate was set on its secondary passthrough income at the average rate for LLC individual members, 8.55 percent for gains, and on its secondary passthrough losses at zero.

3.5.5 Passthrough Tax for Limited Partnership Members

Tax Rate for Secondary Passthrough

The tax rate applied to the secondary passthrough of LLC income through limited partnerships is the average adjusted rate for LLC individual members, 8.55 percent. The tax rate applied to the secondary passthrough of LLC losses through limited partnerships is the average adjusted rate for LLC individual members, 5.44 percent. If the limited partnership member did not file a return with the Franchise Tax Board, the tax rate was set on its secondary passthrough income at the average rate for LLC individual members, 8.55 percent for gains, and on its secondary passthrough losses at zero.

3.5.6 Passthrough Tax for Estates and Fiduciaries

Tax Rate

Gains passed through to estates and fiduciaries for which returns are found are taxed at 8.55 percent. Losses passed through to estates and fiduciaries for which returns are found are taxed at 5.40 percent.

Returns not Filed

Some estate and fiduciary members did not file returns with the Franchise Tax Board. For these taxpayers, the tax impact for gain passthroughs is assumed to be equal to the members' shares of LLC passthrough income times a tax rate of 8.55 percent, the adjusted average rate for individual members discussed above. It is assumed that, if an estate or fiduciary member did not file a return with the Franchise Tax Board and that member received a passthrough loss, that loss would not have a tax effect, since the member has not reported any positive income for the loss to offset.

Tax Rate for Secondary Passthrough

The tax rate applied to the secondary passthrough of LLC income through estates and fiduciaries is the average adjusted rate for LLC individual members, 8.55 percent. The tax rate applied to the secondary passthrough of LLC losses through estates and fiduciaries is the average adjusted rate for LLC individual members, 5.44 percent. If an estate or fiduciary member did not file a return with the Franchise Tax Board, the tax rate was set on its secondary passthrough income at the average rate for LLC individual members, 8.55 percent for gains, and on its secondary passthrough losses at zero.

3.5.7 Passthrough Tax for LLC members

Tax Rate for Secondary Passthrough

The tax rate applied to the secondary passthrough of LLC income through LLCs is the average adjusted rate for LLC individual members, 8.55 percent. The tax rate applied to the secondary passthrough of LLC losses through LLCs is the average adjusted rate for LLC individual members, 5.40 percent. If the LLC member did not file a return with the Franchise Tax Board, the tax rate was set on its secondary passthrough income at the average rate for LLC individual members, 8.55 percent for gains, and on its secondary passthrough losses at zero.